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JAPANESE FISCAL POLICY IN FY 1987: CRACKS IN THE EDIFICE OF AUSTERITY?

Summary

After five years of rigorous fiscal austerity, the FY 1987 budget contains some surprises. While the general account budget remains tightly chained, strong growth is planned for the Fiscal Investment and Loan Program, Japan's capital budget. What makes this year particularly interesting, however, is the subject of tax reform. A reform program of historic proportions has been stalled in the Diet by opposition to a new value-added tax. With the entire tax plan for FY 1987 on hold, tax rules for the previous year remain in effect, throwing budget calculations out of kilter. Uncertainties over Prime Minister Yasuhiro Nakasone's political future as well as insistent calls from abroad for a shift in fiscal policy put the future of both austerity and tax reform in doubt. Japanese fiscal planners are clearly in for some difficult times.

An Ocean of Red Ink . . .

Mr. Nakasone and the Finance Ministry base their policy of fiscal austerity on the need to halt the growth of the national debt. The outstanding public debt as a percentage of gross national product jumped from 16.8 percent in fiscal 1977 to an estimated 43.5 percent in the current fiscal year. The share of current outlays devoted to interest payments on the debt is projected at 20.9 percent in FY 1987, more than double its FY 1977 8.2 percent level. Although Tokyo is rapidly restructuring its financial markets in order to roll over the debt with greater ease, concern over the future impact of the debt weighs heavily on the minds of policymakers.

To stem the red tide, zero growth of discretionary expenditures has been a budget rule for the past five years (see Tables 1 and 2). After great success in fiscal 1984, the policy has just managed to hold the line on spending in subsequent years. The effect of five years of tight budgetary controls is evident. Bond issues as a share of total revenues have fallen steadily from a peak of 39.6 percent in FY 1979 to a projected 19.4 percent this fiscal year, reflecting a steady decline in total issues to levels last seen in FY 1978 (just over ¥10.5 trillion or \$75 billion at ¥140=\$1.00).

... And an Economy About to Sink?

The strong dollar and robust American economy more than compensated for the deflationary effects of a no-growth fiscal policy in the mid-1980s. Although the U.S. economy outperformed Japan's in both 1983 and 1984, Tokyo was content to enjoy a growing trade surplus and steady overall growth. Today, in contrast, policymakers are not at all sanguine about economic prospects. The combination of a sharp appreciation of the yen against the dollar and slower U.S. economic growth has revealed the truth about the country's economic situation -- without significant fiscal stimulation, Japan's economy is highly vulnerable to the shrinking volume of exports. While a policy of fiscal austerity may indeed be the best long-term course, it has tied Tokyo's hands when dealing with the short-term problems of adjusting to the high yen and has also left it open to charges that it is not shouldering its global economic responsibilities.

As the U.S. economic locomotive loses steam, all eyes are turned to Japan and West Germany to take up the slack. Both governments have resisted, although for slightly different reasons. Bonn is worried about rekindling inflation and is quite satisfied with its economic growth performance. Tokyo, on the other hand, raises the deficit issue to ward off criticism. But as its global trade surplus hit levels previously recorded only by the entire Organization of Petroleum Exporting Countries in the 1970s, and its presence in foreign financial markets rose to new prominence, the credibility of this defense has eroded. In fact, a commission appointed by the prime minister has urged in two reports that Japan rapidly restructure its economy to emphasize domestic demand -- in part by loosening the fiscal purse strings (see JEI Report No. 7B, February 21, 1986, and No. 17B, May 1, 1987). These so-called Maekawa reports have apparently been given little more than lip service in Japan. While many regulatory changes have been made, most economists argue that fiscal stimulus must also play a role.

Under these difficult conditions, Japanese policymakers have struggled to balance the goals of debt reduction (which has a great deal of political weight behind it) and solid economic growth. The result is that while austerity continues to hold a hammerlock on the general account budget (the supplemental budget for fiscal 1986 actually reduced spending -- see Table 3), planners are pushing the Fiscal Investment and Loan Program to new heights.

Spending

The general account budget for FY 1987 shows that even Mr. Nakasone is being forced to make compromises (see Table 1). Investment in science and

Table 1: Japan's General Account, FY 1983-FY 1987

(in billions of yen and percentage change)

	FY 1983 (revised)		FY 1984 (revised)		FY 1985 (revised)		FY 1986 (revised)		FY 1987* (initial)	
Total Expenditures	Y50,839.4	6.9%	Y51,513.4	1.3%	Y53,222.9	3.3%	Y53,824.8	2.5%	Y54,101.0	0.5%
Social Security	9,231.3	1.0	9,231.0	-0.0	9,830.8	6.5	10,090.3	2.6	10,089.6	2.6
Public Assistance	1,129.7	4.6	1,139.4	0.9	1,082.2	-5.0	1,110.4	2.6	1,110.1	0.4
Social Welfare	1,917.5	19.6	1,999.2	4.3	2,056.2	2.9	1,977.8	-3.8	2,015.8	6.1
Social Insurance	5,378.9	-4.9	5,347.9	-0.6	5,847.5	9.3	6,137.3	5.0	6,097.4	2.2
Health Service	435.4	2.3	467.0	7.3	464.4	-0.5	497.2	7.1	500.6	0.9
Unemployment	369.8	-1.1	367.5	-0.6	380.3	-0.6	367.6	-3.4	361.0	-0.9
Education and Science	4,834.3	0.0	4,866.5	0.7	4,904.3	0.8	4,886.6	-0.4	4,849.7	0.1
Compulsory Education	2,254.5	1.5	2,302.6	2.1	2,415.2	4.9	2,414.9	-0.0	2,362.3	-0.2
Transfer to School Account	1,015.6	0.0	1,071.7	5.5	1,075.1	0.3	1,083.7	0.8	1,111.4	2.9
Science Promotion	392.0	2.7	410.8	4.8	375.4	-8.6	381.8	1.7	400.6	2.5
School Facilities	489.8	-7.4	427.3	-12.8	385.5	-9.8	350.0	-9.2	314.6	-10.1
School Aid	592.0	-0.5	567.9	-4.1	569.6	0.3	575.7	1.1	578.8	0.3
Student Loans	90.3	-0.5	86.2	-2.3	83.6	-3.0	80.5	-3.7	82.0	1.6
National Debt Service	8,167.5	18.3	9,155.1	12.1	10,180.5	11.2	10,664.4	4.8	11,333.5	0.1
Pensions	1,890.0	-0.1	1,885.8	-0.2	1,863.7	-1.2	1,850.1	-0.7	1,895.6	2.5
Civil Servants	132.7	-2.0	128.2	-3.4	124.8	-2.7	121.4	-2.7	122.3	0.7
Veterans	1,603.6	0.9	1,601.1	-0.2	1,578.7	-1.4	1,562.6	-1.0	1,606.9	2.8
Administrative Costs	10.6	2.3	10.5	-0.9	10.4	-1.7	10.3	-0.0	8.9	-14.0
War-bereaved Families	143.1	-8.2	146.0	2.0	149.9	2.7	155.9	4.0	157.6	1.1
Local Finance	7,672.9	-3.8	9,219.0	20.2	9,690.1	9.0	9,734.7	0.5	10,184.1	-0.0
Local Allocation Tax	7,315.1	-2.9	9,036.1	23.5	9,690.1	6.8	9,734.7	0.5	10,184.1	-0.0
Special Grants	2.0	**	0.0	**	0.0	**	0.0	**	0.0	**
Interest Support	355.8	-19.4	182.9	-48.6	0.0	**	0.0	**	0.0	**
Defense	2,761.0	7.6	2,934.6	6.3	3,169.7	8.0	3,338.0	5.3	3,517.4	5.2
Public Works	7,224.3	-0.8	6,883.5	-4.7	6,922.3	0.6	6,946.3	0.3	6,082.4	-2.3
Erosion, Flood Control	1,107.4	0.1	1,098.5	-0.8	1,082.8	-1.2	1,101.4	1.7	1,060.8	-1.4
Road Improvement	1,893.3	0.1	1,899.9	0.4	1,856.1	-2.3	1,826.3	-1.6	1,740.4	-2.6
Harbors, Airports	524.1	0.3	519.8	-0.8	511.9	-1.5	517.3	1.1	496.5	-1.9
Housing	894.3	1.9	915.0	2.3	927.9	1.4	940.2	1.3	748.4	-1.1
Living Environment	988.2	0.1	980.3	-0.8	970.3	-1.0	989.0	1.9	947.4	-1.7
Agriculture	900.0	0.1	891.9	-0.9	879.0	-1.4	886.9	0.9	850.5	-2.0
Forest Roads and Water	177.1	-0.7	173.2	-2.2	169.6	-2.1	170.4	0.5	163.0	-2.4
Adjustment Reserves	11.4	-3.1	10.9	-3.7	10.7	-2.2	11.3	5.6	10.4	-1.9
Disaster Reconstruction	728.4	-9.6	394.0	-45.9	514.0	30.5	503.5	-2.0	65.1	-25.6
Economic Cooperation	498.2	4.9	543.9	9.2	581.3	7.5	600.5	3.3	649.2	4.2
Small-Business Measures	238.9	-2.2	229.2	-4.1	211.9	-8.0	225.6	6.5	197.3	-3.8
Energy Measures	557.4	-0.3	603.2	8.2	626.2	2.6	570.5	-8.9	495.2	-21.4
Food Price Supports	917.2	-8.8	813.2	-11.3	695.2	-14.0	613.8	-11.7	540.6	-9.3
Miscellaneous	4,383.9	-1.5	4,354.9	-0.7	4,346.9	-0.5	4,104.0	-5.6	3,916.3	-4.1
Others	2,252.5	**	125.3	**	0.0	**	0.0	**	0.0	**
Reserves	210.0	**	170.0	**	200.0	**	200.0	**	350.0	**
Total Revenues	50,839.4	6.9	51,513.4	1.3	53,222.9	3.3	53,824.8	2.5	54,101.0	0.0
Tax, Stamp Revenues	31,902.0	4.6	34,835.0	9.2	38,145.0	9.5	39,440.0	2.3	41,194.0	1.6
Monopoly Profits	1,004.2	31.8	1,024.6	2.0	6.6	-99.4				
Public Enterprise Receipts	15.1	5.1	15.4	2.0	15.9	3.2	2,889.8	18.7	2,403.6	-6.9
Sale of Public Properties	82.7	10.3	92.3	11.6	157.9	71.1				
Miscellaneous	3,843.3	107.2	2,282.6	-40.6	2,254.0	-1.3				
Public Bonds	13,790.0	-3.9	12,865.0	-6.7	12,438.0	-3.3	11,495.0	-1.6	10,501.0	-4.1
General	6,365.0	-2.3	6,225.0	-2.2	5,950.0	-4.4	5,700.0	-4.2	5,520.0	-3.2
Special	6,980.0	13.9	6,455.0	-7.5	5,730.0	11.2	5,795.0	1.1	4,981.0	-5.1

*Percentage changes for FY 1987 are based on the initial budget for FY 1986.

**Cannot be calculated or meaningless.

Source: Ministry of Finance

Table 2: Discretionary Spending in the General Account, FY 1983-FY 1987

(in billions of yen and percentage change)

	<u>FY 1983</u>		<u>FY 1984</u>		<u>FY 1985</u>		<u>FY 1986</u>		<u>FY 1987*</u>	
Total Expenditures	Y50,839.4	6.9%	Y51,513.4	1.3%	Y53,222.9	3.3%	Y53,824.8	2.5%	Y54,101.0	0.0%
Minus										
Debt Service and Transfers to Local Governments	15,482.7	7.2	16,191.2	17.5	19,870.6	5.0	20,399.1	2.7	21,517.6	0.1
Equals										
Discretionary Spending	35,356.8	6.8	33,322.2	-5.8	33,352.3	0.1	33,425.7	0.2	32,583.4	-0.0

*Percentage changes for FY 1987 are based on the initial budget for FY 1986.

Source: Ministry of Finance

Table 3: Supplementary Budget for FY 1986

(in millions of yen)

<u>Increased General Account Expenditures</u>	Y1,403,452
Public Works	549,021
General Public Works	133,000
Disaster Reconstruction	416,021
Promotion of Public Sector Vitality	3,304
Small Business Measures	25,236
Public Employee Wages	133,795
Relief for Northern Fisheries	19,562
Additional Compulsory Expenses	226,677
Special Grants for National Health Insurance	74,000
Housing and Urban Development Corporation Subsidy	173,926
Transfer to the Sinking Fund	8,647
Transfer to the Coal, Petroleum and Alternative Energy for Petroleum Special Accounts	151,000
Other	38,284
<u>Decreased General Account Expenditures</u>	-1,667,262
Reduction in Expenditures	-452,027
Decreased Debt Service Payments	-410,000
Decreased Transfers to the Coal, Petroleum and Alternative Energy for Petroleum Special Accounts	-150,000
Decrease in Grants-in-Aid transfers to Local Governments	-450,240
Decrease in Reserves	150,000
<u>Net General Account Expenditures</u>	-263,810
<u>Increased Revenues</u>	1,702,085
Tax and Stamp Revenues	648,000
Other Revenues	64,538
Public Bonds	549,000
Carried-over Surplus from FY 1985	440,547
<u>Decreased Revenues</u>	-1,965,900
Tax and Stamp Revenues	-1,768,000
Other Revenues	-197,900
<u>Net Revenues</u>	-263,815

Source: Ministry of Finance

technology, along with defense and foreign aid, has been one of his priorities. But while the latter categories have shown steady growth over the past few years, spending on science and technology has been battered. Expenditures for science in FY 1987 have not yet returned to the level recorded three years ago, while outlays for education in general remain stagnant. In contrast, healthy increases in defense and foreign aid (economic cooperation) are again slated for this fiscal year. Among all other categories, only social security expenditures have been allowed to rise.

The most striking cost-cutting is reserved for public works, where a cut has been planned for every line item. Planners have clearly sought every means to ease the pain. The deep cut in energy measures, for example, was made possible by weak global oil prices and the strong yen, while changing politics explain the reduction in food price supports. Pay increases for civil servants and other government employees are apparently to be postponed, since the miscellaneous category, which includes salaries, is set to decline by more than 4 percent.

In contrast to this gloomy picture, the budget for the Fiscal Investment and Loan Program is a bright spot with its projected 40.3 percent hike in spending (see Table 4). Many categories show double-digit increases, much of it for traditional public works projects. The addition of a new capital utilization item in FY 1987 is also encouraging since it will probably be used to start up major projects, such as the Tokyo Bay bridge. Even the FILP, however, shows some evidence of tight-fistedness. Spending for industry and technology as well as foreign trade and economic cooperation have been shifted back to the general account budget or to the private sector in order to conserve funds.

Revenues

If the debate over spending is heated, the controversy over tax policy is white hot. The basic shape of Japan's tax structure was set by the United States during the postwar occupation using its own system as a model. The Japanese system is characterized by a heavy dependence on highly progressive personal and corporate income taxes and a host of special commodity taxes usually linked to specific policies. The oil and gas tax, for example, is intended to promote energy conservation. (For a detailed breakdown of FY 1984 and FY 1985 tax receipts, see Table 5.) Popular dissatisfaction with the existing tax structure is centered on its highly progressive nature and its assessment methods. With an upper national tax bracket of 70 percent and top local rates at 18 percent, it is not surprising that resentment has grown in view of the steady rise in average income over the past several decades. Middle-class families in particular feel victimized by the system. More sensitive, however, is the issue of assessment.

Unlike salaried workers who have taxes withheld at the source, self-employed businessmen and farmers voluntarily report their income, making tax avoidance a relatively simple matter. According to popular belief, 90 percent of the income of salaried workers is taxed compared to 60 percent of those who are self-employed and only 40 percent for farmers. Not only do family-owned firms avoid taxes by under-reporting, but self-employed professionals, including doctors and lawyers, are also said to be discretely lightening their taxes. This assumption is a delicate issue since farmers and small businessmen are important voting blocs.

Table 4: Uses and Sources of Japan's Fiscal Investment and Loan Program Outlays, FY 1983-FY 1987

(in billions of yen and percentage change)

	<u>FY 1983</u>		<u>FY 1984</u>		<u>FY 1985</u>		<u>FY 1986</u>		<u>FY 1987</u>	
<u>Total Outlays</u>	<u>Y20,702.9</u>	<u>2.0%</u>	<u>Y21,106.6</u>	<u>1.9%</u>	<u>Y20,858.0</u>	<u>-1.2%</u>	<u>Y22,155.1</u>	<u>6.2%</u>	<u>Y31,081.3</u>	<u>40.3%</u>
Housing	5,304.1	3.4	5,289.5	-0.3	5,289.3	-0.0	5,856.2	10.7	6,328.2	8.1
Water Works	2,764.8	-3.4	3,007.5	8.8	3,280.9	9.1	3,694.5	12.6	3,998.7	8.2
Welfare	652.0	-7.0	637.9	-2.1	595.7	-6.6	625.9	5.1	627.7	0.3
Education	783.0	2.6	777.1	-0.8	745.3	-4.1	678.2	-9.0	784.1	15.6
Small Business	3,942.2	0.9	3,968.3	0.7	3,764.4	-5.1	3,700.0	-1.7	3,985.6	7.7
Agriculture	963.0	6.2	1,034.8	7.5	890.6	-13.9	902.1	1.3	907.8	0.6
Land Conservation, Disasters	332.5	7.4	379.1	13.8	472.8	24.7	422.7	-10.6	493.0	16.6
Roads	1,583.7	7.5	1,711.7	8.1	1,826.4	6.7	2,024.4	10.8	2,363.0	16.7
Transportation and Communication	1,924.6	-1.2	1,887.6	-1.9	1,763.4	-6.6	2,015.1	14.3	2,264.1	12.4
Regional Development	511.4	-5.0	500.0	-2.2	511.2	2.2	566.1	10.7	657.7	16.2
Industry and Technology	626.2	-1.5	620.3	-0.9	603.3	-2.7	635.9	5.4	630.9	-0.0
Foreign Trade and Economic Cooperation	1,315.4	18.2	1,292.8	-1.7	1,114.7	-13.8	1,034.0	-7.2	690.5	-33.2
Capital Utilization									3,350.0	*
<u>Total Revenues</u>	<u>24,402.9</u>	<u>2.6</u>	<u>24,706.6</u>	<u>1.2</u>	<u>25,858.0</u>	<u>4.7</u>	<u>27,155.1</u>	<u>5.0</u>	<u>31,081.3</u>	<u>14.5</u>
Industrial Investment Special Account	5.2	-72.5	4.8	-7.7	31.4	554.2	61.5	95.9	144.3	134.6
Trust Fund Bureau Fund	19,135.3	-2.2	18,905.2	-1.2	20,029.0	5.9	20,738.6	3.5	24,595.8	18.6
Postal Savings	7,900.0	0.0	6,900.0	-12.7	6,400.0	-7.2	7,000.0	9.4	7,900.0	12.9
Pensions	4,100.0	-4.7	3,850.0	-6.1	3,950.0	2.6	4,300.0	8.9	4,450.0	3.5
Payments, etc.	7,135.3	-3.2	8,155.2	14.3	9,679.0	18.7	9,438.6	-2.5	12,245.8	29.7
Postal Life Insurance Fund	2,354.4	18.8	2,586.6	9.9	2,587.6	0.0	3,145.0	21.5	3,941.2	25.3
Government-Guaranteed Bonds and Borrowings	2,908.0	31.0	3,210.0	10.4	3,210.0	0.0	3,210.0	0.0	2,400.0	-25.2

*Cannot be calculated or meaningless.

Note: All figures are based on initial budgets.

Source: Ministry of Finance

Table 5: Japan's National Tax and Stamp Receipts, FY 1984-FY 1985

(in billions of yen)

	<u>FY 1984</u>	<u>FY 1985</u>
General Accounts	Y34,908	Y38,199
Direct Taxes	26,281	28,517
Personal Income Tax	14,063	15,435
Withheld	11,041	12,249
Self-assessed	3,022	3,186
Corporate Income Tax	11,341	12,021
Inheritance and Gift Tax	877	1,061
Indirect Taxes	8,627	9,684
Liquor Tax	1,860	1,932
Tobacco Excise Tax	*	884
Sugar Excise Tax	42	41
Gasoline Tax	1,647	1,557
Liquefied Petroleum Gas Tax	15	15
Aviation Fuel Tax	52	52
Petroleum Tax	388	400
Commodity Tax	1,495	1,528
Playing-card Tax	0.4	0.4
Bourse Tax	13	11
Securities Transaction Tax	506	671
Travel Tax	77	75
Admission Tax	8	5
Motor Vehicle Tonnage Tax	488	452
Customs Duty	692	639
Tonnage Duty	9	9
Others	0	0
Stamp Revenue	1,335	1,413
Special Accounts	848	951
Local Road Tax**	296	300
Liquefied Petroleum Gas Tax**	15	15
Aviation Fuel Tax**	9	9
Motor Vehicle Tonnage Tax**	163	151
Special Tonnage Duty	11	11
Customs Duty on Crude Oil	128	120
Energy Development Tax	227	233
Naphtha Tax*	*	111
Total	35,756	39,150

*New item.

**Revenue transferred to local governments.

Source: Ministry of Finance

The most recent tax reform effort began in 1985 when the ruling Liberal Democratic Party, at Mr. Nakasone's urging, began an internal study of the issue. After more than a year of discussion, Mr. Nakasone's tax commission and the LDP Tax System Council issued reports calling for the most thorough overhaul of the system since its inception (see JEI Report No. 44B, December 5, 1986). After inter-ministerial discussions, a tax reform package of seven bills including a 5 percent value-added tax was submitted to the Diet at the end of 1986 (see Appendix A).

Unfortunately, the LDP ran into trouble from the start. The opposition parties opposed any major new indirect tax, and in fact, Mr. Nakasone had promised not to introduce one during 1986 lower house elections (see JEI Report No. 25B, July 11, 1986). Every group that traditionally supported the LDP came out against the value-added tax, leading to some dissent within the party itself. Business was particularly unhappy that a wide number of companies and transactions would be exempt from the new tax, which would severely distort the incidence of the tax burden (see Appendix B). While Mr. Nakasone contended that the 5 percent value-added tax was not a "major" new tax, opposition parties rode a wave of popular resentment to gains in local elections. The opposition generated so much popular support that it managed to tie up passage of the FY 1987 budget beyond the April 1 start of the fiscal year, forcing the government to adopt a provisional budget (see Table 6).

Despite its overwhelming majority in the lower house, the LDP was unable to push the budget and tax reform plan through the Diet due to the unhealthy political climate. In a major blow to Mr. Nakasone's political position, the entire tax package was shunted into a special parliamentary committee in late April. Although this cleared the way for the passage of the budget, it doomed the value-added tax for the current fiscal year. The LDP and the opposition parties agreed May 12 to drop the tax but to continue considering other elements of the reform package, including income and corporate tax reductions, changes in the tax-exempt savings system and a restructuring of the tax on alcoholic beverages.

Outlook

The personal and corporate income tax reductions are almost certain to be adopted during an extraordinary Diet session late this summer. In addition, Mr. Nakasone will press for passage of a large supplementary spending bill in order to deliver on his pledge to stimulate the economy. Exactly how the tax cuts and extra spending will be paid for is unclear. With the FY 1987 tax bill on hold, the previous year's tax provisions remain in effect. (For a listing of these provisions, see JEI Report No. 16A, April 25, 1986.) While the potential for a revenue shortfall exists (since FY 1986 tax projections are generally lower), Finance officials report that revenues are running ahead of projections so far this year.

In light of the value-added tax rebellion, the LDP may find it very difficult to raise existing taxes or implement new levies. The problem is equally prickly for the opposition parties because they are fully involved in the special Diet committee considering tax reform. The opposition is solidly in favor of income tax cuts but has few ideas on how to pay for them. The simple solution is to issue more deficit bonds but the Ministry of Finance remains publicly opposed to any backsliding in the drive to reduce the deficit. While the

Table 6: Provisional General Account Budget, FY 1987

(in billions of yen)

<u>Expenditures</u>	Y8,829.0	Harbors, Airports	140.4
		Housing	213.6
Social Security	1,722.0	Living Environment	410.6
Public Assistance	181.8	Agriculture	240.5
Social Welfare	375.6	Forest Roads and Water	46.1
Social Insurance	1,021.5	Adjustment Reserves	0.0
Public Health Insurance	82.9	Disaster Reconstruction	16.0
Unemployment	60.2		
		Economic Cooperation	2.9
Education and Science	510.9		
Compulsory Education	260.3	Small-Business Measures	8.3
Transfer to School Account	116.6		
Science Promotion	22.6	Energy Measures	0.4
School Facilities	77.3		
School Aid	18.7	Food Price Supports	0.0
Student Loans	15.4		
		Miscellaneous	420.1
National Debt Service	1,154.8	Reserves	20.0
		<u>Total Receipts</u>	2,530.7
Pensions	470.1		
Civil Servants	30.4	Tax, Stamp Revenues	878.0
Veterans	402.3		
Administrative Costs	1.3	Other Revenues	72.7
War-bereaved Families	36.1		
		Public Bonds	1,580.0
Local Finance	2,197.2		
		Deficit*	6,298.3
Defense	460.5		
		*Deficit will be financed by issuing Treasury Financing Bills as necessary.	
Public Works	1,861.8		
Erosion, Flood Control	300.7		
Road Improvement	493.8		

Source: Ministry of Finance

idea of stretching out the debt reduction timetable has been mentioned in the past and there have been some rumors in the Japanese press that austerity is losing its unanimous support in the Ministry of Finance, no one idea has gained ascendancy. The likeliest scenario appears to be an increase in existing commodity taxes, the implementation of some new consumption taxes (perhaps on telecommunications, for example), the liquidation of some government holdings in ex-monopolies (including the astronomically high stock of Nippon Telegraph and Telephone Corp.), and new issues of construction bonds tied to specific projects. (Constructions bonds are considered distinct from deficit financing bonds, so it is possible to rationalize that these issues do not add to the deficit.) Only time will truly tell, however.

For further information, contact Jon Choy.

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The views expressed in this report are those of the author and do not necessarily represent those of the Japan Economic Institute.

Appendix A: FY 1987-89 Tax Reform Proposal

Individual Taxes

1. The number of personal income tax brackets at the national level will be reduced from 13 to 11 in 1987, and then to six in 1988. The maximum rate will decline from 70 percent to 60 percent in 1987 and then to 50 percent in 1988 (see Table a).
2. At the local level the number of personal income tax brackets will be reduced from 15 to 12 in FY 1987, and then to six in FY 1988 (see Table b).
3. A special deduction of up to Y112,500 of a spouse's income can be taken in FY 1987.
4. The spouse deduction rises to Y150,000 on national tax returns and Y120,000 on local tax returns beginning in FY 1988.
5. The basic deduction for dependents rises from Y260,000 to Y280,000 for local taxes.
6. Special deductions for public pensions and senior citizens go into effect.

Corporate Taxes

1. Reduction of basic rates and abolition of the reduced rate for distributed profits by 1988 (see Table c).
2. Imposition of a 20 percent tax on dividend income by FY 1989.
3. Phase-out of the tax exemption on reserves for bonuses over a four-year period.

Sales Taxes

1. Imposition of a 5 percent value-added sales tax beginning in January 1988, except for car sales, which will be subject to an 11 percent levy. Companies with annual sales of less than Y100 million will be exempt from the tax, as will the following items: school textbooks; artificial teeth, eyes, arms, legs and other tools for the handicapped; medical treatment without social insurance coverage; and renting of condominiums and other properties. The VAT will be added to existing liquor and tobacco taxes. (For an example of how the sales tax will work, see Appendix B.)
2. In regard to the existing 29 consumption taxes, 20 will be retained (including the gasoline and petroleum taxes), eight will be eliminated (commodity, playing card, admission, travel, sugar, electricity, gas and timber delivery), and one will be restructured (liquor; see Table d).

Interest Income

1. The tax exemption for interest paid on postal savings accounts or special bank deposits of up to Y3 million (the small saver's system or maruyu) will be abolished. Accounts held by senior citizens, the handicapped and one-parent households will still be exempt.
2. Beginning October 1987, a 20 percent withholding tax on interest income from all postal savings or bank deposits will be imposed.
3. A 10 percent tax on interest earned on pension or housing accounts of Y5 million or less will be imposed from October 1987.
4. A 20 percent tax on tax shelters and an 18 percent tax on discount bank debentures and government bonds will be imposed from October 1987.

Housing Deductions

1. The period when a certain percentage of home purchase costs may be deducted will be increased from three to five years.

Securities Transaction Tax

1. The tax on the sale of convertible bonds will be increased from 0.045 percent to 0.26 percent effective FY 1987.

Registration and License Tax

1. Levies will be increased by 50 percent across the board, including real estate transactions, chip registrations, incorporations, medical licenses, patent and copyright fees, and banking and business licenses.

Estimated Revenue Effects of Proposed FY 1987 Tax Reforms

(in billions of yen)

	<u>First Year</u>	<u>Out Year</u>
Individual Income Tax Reduction		
Rate changes	Y-621	Y-1,533
Special spouse deduction	-261	-350
Special FY 1987 treatment for spouse	-133	0
Other special deductions	-3	-67
Total	-1,018	-1,950
Corporate Income Tax Reductions		
Rate changes	-403	-1,531
Interest Tax Changes	45	957
Sales Tax		
Creation of 5 percent value-added tax	1,103	4,971
Abolition of certain commodity taxes	-389	-2,408
Others		
Abolition of bonus payment reserve	397	43
Increased incentives for home buyers	0	94
Increase in securities transaction tax	92	37
Increased bourse tax	14	14
Increased registration and license tax	159	0
Total	0	39

a. National Personal Income Tax Rates

(in millions of yen and percent)

1986		1987		1988	
<u>Taxable Income</u>	<u>Rate</u>	<u>Taxable Income</u>	<u>Rate</u>	<u>Taxable Income</u>	<u>Rate</u>
Y0.5 or less	10.5%	Y0.5 or less	10.5%	Y1.2 or less	10.0%
0.5 to 1.2	12.0	0.5 to 1.2	11.0		
1.2 to 2	14.0	1.2 to 2	14.5		
2 to 3	17.0	2 to 3	16.0		
3 to 4	21.0				
		3 to 5	20.0	1.2 to 5	15.0
4 to 6	25.0				
		5 to 7	25.0	5 to 7	20.0
6 to 8	30.0	7 to 8	30.0		
8 to 10	35.0	8 to 10	30.0	7 to 10	30.0
10 to 12	40.0	10 to 12	40.0		
12 to 15	45.0	12 to 15	45.0	10 to 15	40.0
15 to 20	50.0			Over 15	50.0
20 to 30	55.0	15 to 30	50.0		
30 to 50	60.0	30 to 50	55.0		
50 to 80	65.0	Over 50	60.0		
Over 80	70.0				

b. Local Personal Income Tax Rates

(in millions of yen and percent)

1986		1987		1988	
<u>Taxable Income</u>	<u>Rate</u>	<u>Taxable Income</u>	<u>Rate</u>	<u>Taxable Income</u>	<u>Rate</u>
Municipal Inhabitants Tax					
Y0.2 or less	2.5%			Y0.6 or less	3.0
0.2 to 0.45	3.0	Y0.6 or less	3.0		
				0.6 to 1.3	5.0
0.45 to 0.7	4.0	0.6 to 1.0	5.0		
0.7 to 0.95	5.0	1.0 to 1.5	6.0	1.3 to 5.0	8.0
0.95 to 1.2	6.0	1.5 to 3.7	8.0	Over 5	11.0
1.2 to 2.2	7.0	3.7 to 5.7	9.0		
2.2 to 3.7	8.0	5.7 to 9.5	10.0		
3.7 to 5.7	9.0	9.5 to 19	11.0		
5.7 to 9.5	10.0	19 to 29	12.0		
9.5 to 19	11.0	Over 29	13.0		
19 to 29	12.0				
29 to 49	13.0				
Over 49	14.0				
Prefectural Inhabitants Tax					
Y1.5 or less	2.0%	Y1.2 or less	2.0%	Y5 or less	2.0%
Over 1.5	4.0	1.2 to 3.7	3.0	Over 5	4.0
		Over 3.7	4.0		

c. Corporate Income Tax Rates

(in percent)

	<u>FY 1986</u>	<u>FY 1987</u>	<u>FY 1988</u>	<u>FY 1989</u>
Basic Rates				
Retained profits	43.3%	42.0%	40.0%	37.5%
Distributed profits	33.3	34.0	35.0	37.5
Small-Corporation Rates*				
Retained profits	31.0	30.0	29.0	28.0
Distributed profits	25.0	26.0	27.0	28.0
Cooperatives and Non-profit Corporation Rates**				
Retained profits	28.0	27.0	27.0	27.0
Distributed profits	23.0	25.0	26.0	27.0

*Corporations with equity capital of less than ¥100 million and profits less than ¥8 million.

**Also includes medical-care corporations.

Notes: New rates will apply to books closed after April 1, 1987; rates for liquidation and construction corporations will be adjusted.

d. Liquor Taxes

(in yen per kiloliter)

	<u>Typical Alcohol Content</u>	<u>Current Tax</u>	<u>New Tax</u>
Sake, Special class	15%	¥570,600	*
First class	15	279,500	¥218,500
Second class	15	107,900	67,800
Synthetic Sake	15	81,500	55,100
Shochu, Type A	25	78,600	52,100
Type B	25	50,900	21,900
Mirin, Type A	13.5	74,100	40,700
Type B	22	63,500	39,400
Beer	n.a.	239,100	206,100
Fruit Wine, Pure	n.a.	60,400	*
Other	n.a.	49,700	20,100
Sweetened Wine	12	117,300	63,900
Whiskey and Brandy, Special class**	43	2,098,100	1,636,380
First class**	40	1,011,400	1,522,200
Second class***	37	296,200	*
Other Spirits	37	361,800	243,800
Liqueurs, Type A	15	367,000	*
Type B	12	117,000	63,900
Miscellaneous Liquors	12	117,300	63,900

*Combined with following category.

**Although Special class whiskey and brandy will be classified with First class, figures are calculated on different alcoholic strengths.

***Second class whiskey and brandy will be classified with Other Spirits.

Appendix B: Value-added Tax Example

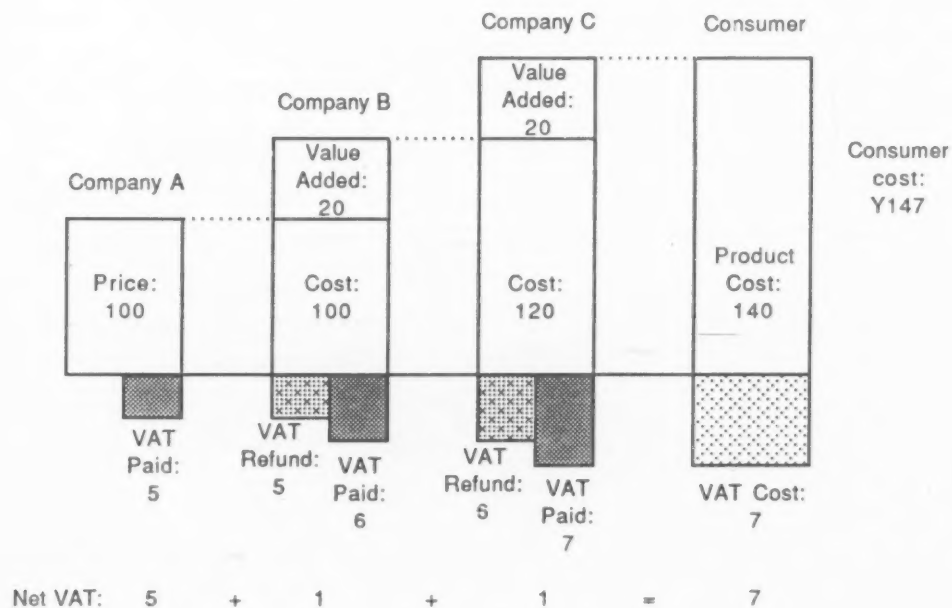
a. Transactions with non-tax-exempt firms

1. Company A imports a raw material and sells some to Company B for Y100. Company A pays the entire 5 percent tax, equal to Y5, since this is an initial transaction.

2. Company B processes the raw material, adding Y20 worth of value before selling it to Company C for Y120. Company B must pay 5 percent of Y120 or Y6, but can claim a deduction for the Y5 Company A paid when it sold the raw material.

3. Company C processes the goods it bought from Company B, adding another Y20 worth of value. Company C then sells the final goods to the consumer for Y140. Company C must pay Y7 in sales tax, but since it can claim a deduction for the Y6 Company B paid, its net liability is Y1.

4. The consumer is faced with a total cost of Y147: Y140 in actual product costs, and Y7 in sales tax. Therefore, the entire transaction yields Y7 to the government in taxes.



b. Transactions with tax-exempt firms

1. Company A imports a raw material and sells some to company B for Y105: Y100 worth of goods, plus Y5 in sales tax. Company A pays the entire 5 percent tax, equal to Y5, since this is an initial transaction.

2. Company B is tax-exempt. It processes the raw material, adding Y20 worth of value before selling it to Company C for Y125.

3. Company C processes the goods, adding another Y20 worth to its value before selling it to the consumer. Company C must pay Y7.25 in sales tax (5 percent of Y145) and it cannot claim any deduction from the previous transaction since Company B is tax-exempt.

4. The consumer is faced with a total price of Y152.25: Y145 in product cost, and Y12.25 in sales tax. Under this circumstance, the entire process yields Y12.25 in taxes and unevenly distributes the tax burden among the three companies.

